4 August 2010

THE FACTS ABOUT QUEENSTOWN AIRPORT'S PARTNERSHIP WITH AUCKLAND AIRPORT

Queenstown Airport Corporation's (QAC) recent decision to issue shares and form a strategic alliance with Auckland Airport has provoked much discussion and interest in the local community. On behalf of QAC's independent board of directors, I would like to give you some information about the transaction, the integrity of the board's decision and the significant benefits it will bring to the Queenstown Lakes District. I invite you to read and examine this information so that you are better informed.

Queenstown Airport needs a partner for growth

The partnership with Auckland Airport has been carefully considered.

Over the past five years, our international passenger volumes have quadrupled and domestic passenger volumes have increased 22% - that makes us the fastest growing airport in the country. But we must invest more money to upgrade and expand airport facilities to keep up with growth.

Imagine if when approached by an airline to accommodate several new trans Tasman direct flights (as has occurred recently), we had to say "sorry, we don't have capacity".

The airport is many visitors' first and/or last impression of our region and it is important that their experience is not tarnished by excessive delays arising from congestion. The current terminal has a design annual capacity of 700,000 passengers. In the year to June 2010 we saw 811,000, we are forecasting 945,000 for 2011 and 1,200,000 for 2015.

We need to invest around $40 million to expand the capacity of our facilities over the next three years. While part of this will be funded from operating cashflows, a significant amount needs to come from other sources. Essentially, this meant either raising more debt, more share capital from our existing shareholder, or introducing a new shareholder (some parties have suggested we could also issue bonds, but bonds are simply another form of debt to the company).

Following recent capital spending (the new terminal, 10 year runway overlay and partly completed Runway End Safety Areas), QAC's debt rose to $36 million and the three-year development programme would have pushed this to in excess of $50 million. These developments include: a new back of house baggage make up area, extensions to the international terminal, new jet hard stands, and a taxiway (currently the runway is the taxiway, limiting the jet aircraft movements to six per hour).

Such higher debt levels would have exposed the airport company to greater financial risk – with serious consequences if, say, there was an economic downturn and tourism traffic fell, or if interest rates rose significantly. Queenstown operates in a global visitor market and we are not immune from adverse global economic conditions or shocks such as the recent swine flu pandemic. Along with our own assessment of financial stability risk, we cannot ignore comments such as those recently made by Ben Bernanke, Chairman of the US Federal Reserve, who described the global economic environment as "unusually uncertain".

Suggestions have been made that QAC could have worked with airline customers to help fund development, as happened several years ago when the existing terminal was being built. Under that arrangement, Air New Zealand and Qantas (the two commercial airlines then operating at Queenstown) agreed for new airport charges that factored in a commercial return on the terminal investment to commence immediately prior to work on the new terminal building. Although QAC still took on the additional debt needed to finance the terminal, the arrangement allowed QAC to generate some "super profits" in the initial years during construction before the higher interest and depreciation costs associated with the new terminal kicked in. The flip side was that the new charging schedule would stay in place for an extended period, from 2004 to 2012. In essence, QAC was able to "front end" some of its earnings at the expense of lower earnings in later years. However, it is important to remember that this arrangement was based on charges for actual aircraft and passenger movements – so QAC bore all the risk if, as mentioned earlier, there was a downturn in air travel into Queenstown due to economic or other factors. QAC was prepared to accept that risk on this previous occasion, as it had only $8 million of debt prior to construction. In 2010, with a debt of $36 million already (much of which related to the earlier investment in the new terminal), the QAC board considered a similar arrangement with airlines would not be suitable.

Given the importance of the role Queenstown Airport plays for the community and the local economy, the QAC board did not believe it was prudent to put the airport's ability to fulfil that role at risk in terms of high levels of debt. Nor could we accept capacity constraints due to a lack of capital for investment. It was also apparent that our existing shareholder Queenstown Lakes District Council (QLDC) would be unable to subscribe for new shares. Like the airport, the district has been growing rapidly and QLDC's financial resources have been stretched by the need to invest in essential infrastructure. Indeed, rather than putting more money in, the Council would prefer to start receiving income (via dividends) from its long-standing investment in QAC which has not generated a financial return to date. So the logical conclusion was to introduce new capital via a new shareholder. This greatly reduced financial risk and allowed QAC to fund the airport's next stage of growth. It also gave the company a stronger capital structure that would enable it to provide its shareholders with a commercial return over the coming years.

Ultimately, these fundamental commercial considerations significantly outweighed consideration that the company should maintain at all costs QLDC's 100% shareholding. Whilst maintaining a 100% shareholding might be seen as a worthy regional ideal, it did not stand up to the commercial scrutiny of the situation faced by QAC. To have done so would in fact have constrained the airport's growth and limited its potential contribution to the local economy and community.

It is also important to remember that QLDC has not reduced its financial investment in QAC. Since Auckland Airport has contributed fresh capital, the overall value of the company has increased. It's a bit like someone with a piece of land who can't afford to develop the land or raise debt and they bring in a shareholding partner to contribute cash to help develop that property further and increase its value. This is a regular business occurrence. Indeed, formation of alliances and new shareholder investment has been a successful feature of several of Queenstown's more prominent tourism businesses in recent years. Today, QLDC's 75.01% shareholding in QAC is worth as much (if not more) than the 100% it previously owned. In fact, we are now in a position to distribute an annual dividend to QLDC to help community finances.

The time (and price) was right

Some people have questioned why we did this transaction now and how the price was negotiated.

With the support of commercial advisors, we modelled the future economic value of the airport under various scenarios. We looked at what would happen to valuations if passenger volume growth was higher or lower than expected, if interest rates went up or stayed at low levels, and so on. The conclusion was that, on balance, now was the right time to bring a new shareholder on board.

Notwithstanding our requirement for capital, if we waited a year or two and market conditions moved against us, there was a significant risk we would be forced to issue new shares at a lower price than we can get today. Consider what might happen to the airport's value if there was a sudden drop in passenger volumes. An example is Cairns Airport in north Queensland, Australia: like Queenstown, Cairns is highly dependent on tourism but after the bottom fell out of the Japanese tourist market, international passenger volumes fell 46% in the four years 2006-2010. While passenger volumes are beginning to recover, they are not expected to reach 2006 levels again for at least five years. In contrast, with exceptional recent growth, bullish forecasts and low interest rates QAC is arguably at a "sweet spot" in terms of its value.

The price paid by Auckland Airport was determined through commercial negotiation. This was backed up by valuation advice from our expert commercial advisors. Valuing an airport business is a relatively straightforward process once you have agreed on a model that factors in future growth in airport revenues and costs. In short, the directors believed Auckland Airport paid a commercial price that reflected a strong growth outlook.

It's not just about the money

Some people have asked why we didn't 'test the market' with other potential shareholders.

If it was just about raising capital, there would have been no shortage of potential partners locally and further afield. But we saw the opportunity to partner with someone with similar goals and aspirations that could bring value on many levels. Above all, we needed to bring maximum value for all the Queenstown community. This was more than selling something for the best price; this was about a partnership to deliver long-term benefit for the community by supporting local tourism growth aspirations.

We saw Auckland Airport as a uniquely ideal choice for partner, for several reasons:

- Auckland Airport is New Zealand's principal international gateway, especially for visitors arriving on direct long-haul flights from Asia or the Americas.

- Auckland Airport has strong relationships with international airlines and the travel industry which it will use to encourage more traffic into Queenstown. In the last year alone, for example, their business development team has made 89 separate visits to countries across four continents and presented over 50 business cases to airlines.

- Auckland Airport invests millions of dollars each year into tourism promotions targeted at specific air services. Much of this will now be focused on Queenstown. Auckland Airport has a wealth of tourism market intelligence that can supplement our own.

- Auckland and Queenstown Airport have shared goals and objectives. We both want to grow passenger volumes and we don't compete for the same passengers. For instance, runway limitations mean Queenstown can never attract the big jets that fly into Auckland – but by working closer with Auckland, we can encourage more passengers on those aircraft to connect with flights to Queenstown.

In short, no other prospective partner could match what Auckland Airport offers and we saw value in forming a strategic alliance with them. As most of the benefits from this alliance will flow to QAC, we needed to ensure that Auckland Airport was incentivised to maximise the alliance. We decided the best way to cement the alliance was to allow Auckland Airport to invest in a minority shareholding so that they had some "skin in the game". Not only would this ensure the partners were financially aligned, it would ensure QAC had the growth capital it required. The alternative would have been a potentially messy service agreement under which QAC paid fees to Auckland Airport for its alliance efforts - which would have presented risk in terms of debate about whether QAC was getting value out of any such fees. This is assuming Auckland Airport would have even been interested in entering such a service agreement.

The QAC board and QLDC followed due process

This decision to issue shares was made by the QAC board, a group of independent and local people who are committed to ensure the best outcome for the development of the airport and the community. The 24.99% shareholding was negotiated and confirmed by the board under powers included in the constitution given to it by QLDC. This power in the constitution was used exactly as designed – to allow the board to exercise commercial judgement in the best interests of the airport and the community. Best business practice and good corporate governance is all about having clear rules that delineate the respective roles of shareholders, directors and managers – and QLDC established clear rules for QAC within its constitution. This position was aptly described in a recent letter to the Otago Daily Times by Mr Peter Gray, a former Chair of the QLDC Finance, Audit, Property and Corporate Committee (the body QAC directors report to, now known as the Finance and Corporate Accountability Committee), former President of the Institute of Accountants and former KPMG partner: *"Congratulations to the Board for doing exactly what they were appointed to do - make a sensible commercial decision in a de-politicised environment, and which was fully in accordance with the Corporation's constitution."*

Arguably, the QAC board could have issued more shares (up to the desired 30-35%) to Auckland Airport without QLDC approval. However, the board decided it would not be appropriate to move beyond 24.99% without a council process involving community consultation. In the board's opinion, the certainty of price, timing and partner meant it made sense to proceed immediately with the initial 24.99% shareholding. The 24.99% is significant as QLDC retains full control with its shareholding at 75.01% and Auckland Airport remains a minority shareholder with no shareholders' agreement and no board representation.

This decision means QAC management can move forward with certainty, confident the company has the capital strength to support its ongoing development and return a flow of benefits to the local community. QAC can work with Auckland Airport as part of their management strategic alliance to grow tourism, and work together on operational synergies to reduce costs and improve efficiencies in the roll out of future capital investment and property portfolio projects.

The strategic alliance should significantly boost Queenstown's growth

Over the five years to 2015, Queenstown Airport has been projecting passenger volumes to increase by about 32% - that's about 260,000 extra annual passenger movements. The strategic alliance is targeting an additional 176,000 movements <u>on top of this</u> – boosting the five year increase to 54%. Additional passenger movements generated by the alliance will translate into more than 78,000 more visitors into the district. About two thirds will be overseas tourists, the rest domestic travellers. Based on average spend rates, these visitors will be worth well in excess of $150 million annually to the local economy[1]. That's money that would not be coming here if it wasn't for the strategic alliance. Work on the plan to achieve this growth has already begun.

This has nothing to do with airport charges

Some critics of the deal (including one airline) have claimed it will result in increased charges for aircraft landing at Queenstown Airport. This is nothing short of scaremongering. Airport charges are not set on a whim. They are designed to earn a fair commercial return on the many millions of dollars invested into essential long-term airport infrastructure. In addition, airport charges are only a relatively small proportion of the overall traveller cost; according to the International Civil Aviation Organisation and Airports Council International, airport charges average only 4% of airlines' total operating costs (that percentage would vary from route to route depending on a range of factors).

That said, airport charges represent a cost for airlines and like any business, they are naturally keen to reduce their costs as much as they can. It's therefore not surprising that there is ongoing debate between airports and airlines about the methodology used to establish charges. However, the Commerce Commission is currently developing a new regulatory framework that is intended to largely resolve that debate. New Commerce Commission guidelines are due to take effect from 1 July 2011. Although these will initially apply to New Zealand's three largest airports, they will influence other airports.

There is simply no business logic to claims that Auckland Airport intends to 'constrain growth' at Queenstown Airport by increasing charges. With a 24.99% shareholding, Auckland Airport is strongly incentivised to grow tourism traffic by working with airlines and the travel sector on air services development. In any case, decisions about Queenstown Airport operations including airport charges will still be made by QAC's management and board, not by any minority shareholder.

We are focused on making the alliance work for Queenstown

The alliance has set some ambitious goals towards achieving stronger visitor growth into Queenstown. Growth in passenger volumes is the lifeblood of any airport. Through our strategic alliance, the country's number one travel gateway and premier tourist destination will work closer together. We know this can be highly effective as we have already been co-operating informally with Auckland Airport in international marketing over the past year or so. We've had a very positive response from airlines and the travel trade from our ability to create stronger North/South Island itinerary propositions.

There is good potential for the alliance to target promotions in key Asian markets (e.g. Japan, Korea, Taiwan, China) for visitors to purchase airline tickets all the way to Queenstown (via Auckland) from their country of origin. We will also encourage more Aucklanders to fly to Queenstown on short breaks – we've already launched a promotion with House of Travel that features a special deal to stay at Millbrook Resort as well as discount carparking at Auckland Airport. In addition, Auckland Airport does not experience the same extreme seasonal peaks and troughs in traffic volumes that Queenstown has, so there is potential to drive more traffic into Queenstown during low periods via promotions.

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[1] Based on tourism data for average spend rates and average length of stay for international and domestic visitors to Queenstown. An economic multiplier was then applied that assumed for every dollar of direct visitor spend, there would be at least another dollar of spin-off economic benefit.

Earlier this year Air New Zealand, Qantas, and Pacific Blue all increased their services into Queenstown. The recent announcement by Jetstar of additional flights into Queenstown from Auckland, Gold Coast and Melbourne is also an example of the way forward (although this deal pre-dated our alliance). Expect itineraries supporting "triangular" routes between Auckland, Queenstown and Australian airports to utilise aircraft efficiently and create better schedule options, such as morning departures to Australia.

Option for Auckland to Increase Shareholding from 24.99% to 30%-35%

There has been plenty of comment, much of it misinformed and confusing, about the possibility of Auckland Airport increasing its shareholding. As part of the arrangements, QAC may exercise an option for Auckland Airport to increase its shareholding to 30-35% at any time up to 30 June 2011. The option is for QAC to determine but before deciding, QAC must seek approval from QLDC as majority shareholder. QLDC has indicated it would consult with the community before giving any such approval. As part of any increased shareholding, Auckland Airport would also enter into a shareholders' agreement with QLDC. This is a common business practice in such shareholding situations and would formalise the relationship between the shareholders. This will be conditional on QLDC being happy with the agreement in all respects.

The price Auckland Airport would pay for any additional shareholding is higher than it paid for its 24.99% shareholding. For any additional shareholding, the agreed value placed on QAC is $90 million ($126 million total value less $36 million debt). The price for the initial shares was $6.91 each (total consideration of $27.7 million, at an implied multiple of 13.1 times 2010 EBITDA) but for additional shares the price would be $7.47 each plus a lump sum payment of $2.2 million (implying a multiple of 13.9 times 2010 EBITDA for the entire holding). The higher price reflects that a 30-35% shareholding (with a shareholders' agreement) is worth more than a 24.99% shareholding. By constructing the transaction in this way, QAC ensures it receives significant further financial benefit from any additional share issue if the community agrees.

In the event Auckland Airport subscribes for additional shares, there would be up to $20.7 million of further new capital. A stronger capital base would enable QAC to make a one-off payment to QLDC of up to $10 million (via a special dividend or alternative means). It would be entirely up to QLDC to determine how this money should be used in the community. Additionally, as a properly capitalised company, QAC would be in a position in normal market conditions to pay regular dividends to its shareholders. QLDC's dividend income would be in the order of $2 million and growing per year.

Summary

In summary, the QAC Board decided:

1. Significant new capital was required to meet the growth needs of the airport.
2. It was not prudent for the QAC to have an elevated debt profile or be growth constrained due to a lack of capital.
3. The preferred route to minimise debt risk and obtain the necessary capital for growth projects was via injection of new share capital – presently unavailable from QLDC.
4. The timing was right to maximise the value of any new share capital through a new shareholder.

5. In introducing new capital via a new shareholder, the new shareholder must be aligned to the strategic goals and intent of QAC - and be able to add value beyond just a monetary contribution.

6. Maintaining a 100% shareholding by QLDC at all cost would have constrained Queenstown Airport's growth and limited its ability to contribute to the local economy and community.

7. Auckland Airport presented a uniquely suitable new shareholder who was prepared to pay a commercial price and also commit to formal alliance agreements which are undoubtedly to the benefit of QAC and the region.

8. The introduction of new capital as part of the partnership unlocks the financial potential of QAC and will allow the company to generate a financial return to its shareholders – ensuring the whole community can benefit (via dividends to QLDC) from the airport's continuing growth.

Thank you for taking the time to read this letter. I hope it has given you a better sense of this matter and helped you understand why we believe this move is in the best interests of QAC and Queenstown Lakes District. Should you have further concerns or queries, please don't hesitate to get in touch with me on 03 450 1854 or Steve Sanderson, QAC's chief executive officer on 03 4509031, steve@queenstownairport.com.

Yours sincerely

Mark Taylor

Chairman

On behalf of the Board of Directors of Queenstown Airport Corporation

My fellow board directors are:

Alison Gerry

James Hadley

Murray Valentine